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Pleydell, Arthur C.

Shifting the tax

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AN ADDRESS ON

THE INCIDENCE OF TAXATION

BY

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SECRETARY NEW YORK TAX REFORM ASSOCIATION

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THE INCIDENCE OF TAXATION

By A. C. Pleydell

Secretary New York Tax Reform Association, New York City

If the people understood who really pays each of the various taxes, there would be great changes in our present tax systems. But there will not be complete reform until it is understood also who ought to pay the taxes. No discussion of the incidence of taxation can be profitable unless in addition to pointing out just who bears the burden of the tax we consider also who should bear the burden.

To show how taxes can be shifted, may result in popular attempts merely to unload burdens, unless it be shown also that unjust taxes injure every one, and not only those who actually pay them.

Technically the "incidence of taxation" refers to the final resting place of the tax, and "shifting" indicates the method by which the tax is passed on from the one who first pays it to the one who finally pays it. But the terms "incidence" and "shifting" are so often used interchangeably that for practical purposes we can speak entirely of "shifting" the tax.

A shifted tax means that the person who pays it to the government gets it back, through an increased charge, from some one to whom he sells or hires property or services. When the positive statement is made that a certain tax is shifted, it must be assumed that the law is enforced. Taxes that are not effective are not all shifted, even though they would be added to cost immediately were the law enforced.

Nearly all of our States have the general property tax, which in theory requires all property to be assessed and taxed at its real worth in money. But every one knows that such laws are not enforced, and the actual shifting of the tax upon any one kind of property is regulated by the degree of severity with which that property is sought for by the assessor.

Shifting is of various kinds and degrees. Some taxes do not increase prices by as much as the tax, because attempts to enforce the law are not made or are ineffective, and the tax is generally evaded. Some taxes increase prices by more than the tax because they restrict competition. Two kinds of taxes are not shifted: those levied upon a person as an individual or upon goods in his possession for use, and taxes on monopoly.

It is impossible in a brief paper to discuss the shifting of all kinds of taxes, with the modifications that result from the non-enforcement of law, or from the competition of other classes of goods or of persons less heavily taxed. But a few general principles and a few examples will cover the various classes of taxes.

With the increasing complexity of our social organization an increasing amount of taxes are paid to the collectors by persons who immediately add them to the price of goods or services. These taxes may, for convenience, be spoken of as shifted directly.

In this class are all the various taxes on manufacturing and business that add to fixed charges, and must be collected from customers or the manufacturer or merchant cannot continue in business.

Here we see the modifying effects of varying laws. Goods are sold in an open market, and the manufacturer whose machinery is heavily taxed has to sell in competition with those who are taxed lightly or not at all. He cannot, of course, add all his tax to the price of his goods. But the fact that he must add some of it keeps him from successful competition with the untaxed manufacturer, and tends to increase the price to the consumer, and to increase also the profits of the untaxed manufacturer. So the consumer pays the tax bill, indirectly, while the taxed industry languishes or moves to a more favorable State.

Taxes on the goods of merchants are similar in effect. The corner grocer must make a living, and the taxes on his merchandise must be paid by his customers. The man who can keep his taxes down will be able to undersell competitors and drive them out of business. If such taxes are strictly enforced in one town and not in another, the overtaxed man who raises

his prices drives away those of his customers who can deal elsewhere; and those who cannot will have to pay the tax through higher prices. They will have to pay also the increased cost of doing business on a small scale, for the merchant must shift it to them or go out of business; and they must put up with poorer service.

Decreased business means smaller rental value for the location. Thus excessive or arbitrary taxes on trade have an adverse effect on landowners, even if not exactly shifted to them.

Sometimes taxes are not shifted to the consumer because of ignorance. The business man who does not properly add his taxes to his prices will go out of business sooner or later, and wonder why he failed.

Mercantile licenses, though also paid by the consumer, have two advantages over the personal property assessment. They are effective, and thus prevent any advantage from evasion. If they are scaled according to receipts, they bear with practical equality on all merchants of the same class. Though they may be out of proportion to the respective rates of profits of a grocer and of a jeweler, still they treat all jewelers alike and all grocers alike. Of course, such taxes are also passed along to the consumer, and may bear with great inequality on various classes of purchasers.

Licenses at a fixed rate are more objectionable, and if at a high rate tend to establish a monopoly by limiting the number who have enough capital to pay the tax. This is seen particularly in the liquor taxes, which greatly increase the price of drinks and the profits of the liquor business.

The corporate form of conducting business is an improvement in commercial mechanism that decreases cost of production. Special taxes on competitive business corporations in excess of taxes on individuals or firms tend to check the use of this more efficient method of conducting business and add to the cost of using it. The burden falls partly on those who are enterprising enough to engage in this form of business, and partly on the consumer who pays a higher price because of the restraint on improvement in production.

Taxes on various forms of intangible property employed in commercial business, such as book credits and bank deposits,

add to expenses and are shifted to the customer. Taxes on such property when used otherwise are shifted to the borrower who is the consumer of the service done for him by the creditor. The shifting, however, is more indirect than is generally the case with taxes on goods.

The experience with mortgage taxation in New York illustrates how these taxes are shifted, and the principles are the same in the case of other forms of interest-bearing credits.

Prior to 1905 mortgages in New York were liable to personal property tax, though most of them escaped assessment. Therefore, though the few that were caught paid a tax of $1\frac{1}{2}$ to 3 per cent, according to locality, the interest rate was only slightly increased by the tax — about enough to cover the risk of being caught. Still, all borrowers paid this increased rate; a few lenders paid much more than the increase to the tax collector; and most lenders kept the added charge.

Then (in 1905) an effective tax was adopted, which the borrowers were forbidden to pay, and though the tax rate was only $\frac{1}{2}$ of 1 per cent in place of the higher personal property rate, interest rates rose at once, while loans declined. A year later a lighter recording tax was adopted, and interest rates fell, while loans increased — even though the borrower paid the tax and knew that he paid it.

Because taxes on certain forms of property, such as mortgages and money, are imperfectly collected, and therefore are not all added to the charge for loans, it is often asserted that the lender pays them. Every enforcement of such taxes has proved the contrary, by increasing the troubles as well as the expenses of borrowers, and reflection will show that it cannot be otherwise. The man who has the money expects a certain net return; if he cannot get it from one source, he will turn to another. Certainly, if another investment will yield him 3 per cent net, he will not accept 4 per cent interest on a mortgage and then pay 2 per cent tax. But the borrower needs the money, and he has to pay the market rate or go without. Suppose a 6 per cent tax were placed on all mortgages; would any sane man expect to borrow mortgage money at 5 per cent? How many people would leave their money on deposit for 3 per cent or 4 per cent if they were compelled to pay 5 per cent

tax on it? And with the money withdrawn from the loan market, how would the borrowers from the banks fare?

It has been said that taxes on capital could not be shifted if they were imposed uniformly and effectively on every sort of capital. Of course it is impracticable to secure such universal taxation. But suppose this could be done. Still capital would seek the best-paying investment as water seeks its level. The taxes on manufactured goods being paid by the consumers, capitalists would put their money into business directly and cut down mortgages or similar loans until interest or premiums rose sufficiently to cover the tax. No one has ever shown how a universal tax on capital could be adjusted so that no kind of capital could shift the tax — and when one kind did so shift the tax, other kinds would insist on getting the same net return.

The taxes on invested capital, as such, are many in kind, but all of them are shifted to the user, who in this case is the borrower, unless they are enacted during the term of a contract. If a State in which mortgages are exempt should suddenly tax them, all lenders who were caught would pay the tax until their mortgages were due. But this does not really affect the question, since argument on the shifting of taxes must assume the law to be stable as well as effective.

Bonds may seem an exception to the rule that the borrower pays the tax, as their holders are frequently assessed, and the interest rate apparently is not affected. But the bond is a mortgage with fixed interest, of which the principal value frequently fluctuates. Instead of demanding higher interest the buyer discounts the tax and pays less principal to the issuer, who, as a borrower, pays the tax through this reduction in the loan.

Here, again, lack of effective taxation creates confusion; the purchase of bonds by persons who escape assessment tends to keep up the price, so that the holder who gets caught has to pay more than his share.

Taxes levied directly on a person or on goods in possession for his consumption cannot be shifted. Such taxes are various, but all of them are vicious. A familiar one is the poll tax, that charges a man for being alive, and when he can't pay it, often puts him in jail where he can't earn anything. He is not killed, even though he has not paid this tax for living, because his friends would then lose interest in him. Like a prisoner of war, he is held for ransom; and if he has no friends, the compassion of strangers is counted on to pay the tax and costs.

Another familiar tax is that on household goods or on clothing. Such taxes are really confiscation, for if a man has to pay $10 a year tax on his furniture, he will soon have paid out the entire value in taxes, and never have made a dollar from the furniture with which to pay the tax. Thus he has paid for the furniture twice; in effect, the government has each year taken part of his furniture from him, and he has replaced it. And this is in addition to all the taxes on makers and sellers of furniture, which he paid in the purchase price of the furniture.

The inheritance tax is not shifted. When a person gets an inheritance, it becomes taxable property (usually), just as it was before it changed hands. But there is an additional tax because of the transfer of ownership; and the tax is really not on the property, but on the right to take for use property that has been given away because of the death of the former owner. The attempt to justify inheritance taxes as a charge for a privilege given by the State is an attack on private ownership of property. The right to inherit or bequeath is as essential to ownership as the right to buy or sell. Certainly the State is entitled to payment for services, but these are charged for in surrogates and other usual fees. However, as inheritance taxes are effective, and fall with fair equality as between individuals if properly levied, they are, if moderate, less burdensome than many other taxes.

A tax on incomes cannot be shifted, if levied regardless of occupation. If it applies only to some occupations, like a mercantile license or a professional tax, it will tend to be shifted through increased prices or earnings. If the tax rate is the same on all incomes, whether from earnings or business or investment, the tax burden will be heavier on workers than on investors.

The usual objection to income taxes is that they are inquisitorial. There is no doubt that an income tax is more fairly

proportioned to ability to pay than is the ordinary personal property assessment, since it does not fall upon unproductive personalty, and bears some relation to earning power of people or property. But an income tax does not fall at all in proportion to benefits.

It is often forgotten that when Adam Smith said taxes should be levied in proportion to ability to pay, he gave as the reason that ability was the best measure of the benefits received from government, which he deemed the real basis. Our assessing machinery does not fairly measure ability, and in our times better methods of measuring benefits than by ability have been worked out. These methods are the outcome of the principles of taxation laid down by Henry George, in accordance with Adam Smith's formulas. As a consequence it is coming to be understood that uniform assessment of all property is unjust because of the varying income-producing power and the greater variation in benefits received from government expenses.

One of the contributions of Henry George to this modern thought is his clear exposition of the exact relation between certain forms of public expenditures and the increase in site values of land. So immediate is this relation that it may perhaps indicate the line between those functions that are governmental in nature and those that are private. For instance, the maintenance of streets confers varied benefits, the value of which to each user cannot well be measured in money; yet each improvement in the highway is reflected in the increase of rents, which measure the worth of the improvement to the inhabitants. But in the case of a gas plant, the benefit to each user of gas is measurable. Though rents would rise if gas were supplied free out of the tax fund, the increase would bear no relation to the savings in gas bills to individual consumers. Such enterprises if municipalized should be run on a business basis, each consumer paying directly for what he gets.

Though this may seem a digression, it bears directly on the question, who should pay the taxes? If, on the one hand, it is just that the owners of ground values should pay for whatever governmental services enhance their holdings, on the other hand, it is unjust to tenants to raise rents artificially by furnishing services free which should be paid for by the users.

Taxes on monopoly cannot be shifted. But just in the degree that a monopoly is imperfect and open to competition, taxes on it tend to be shifted in proportion as the tax rises. To illustrate: A railroad is an incomplete monopoly; besides the possible construction of a competing line, there is usually some form of water or trolley competition; and there is always the marginal passenger or freight that does not need to travel, or will not if rates be too high. Rates may be all the present traffic will bear, but if taxes go above a certain point the rates must go up also, even though traffic will be reduced. The same principle applies to various other public service corporations. For instance, the amount of gas or electricity used depends on the price keeping down the use of oil or candles; and rates must be low enough also to induce a generous illumination. There is always a marginal consumer who can use less light or none. But a tax of $1 a thousand feet on gas would force a rise in rates, however much the higher price reduced consumption.

To one form of public service corporation values, however, this principle does not apply. In so far as rates are higher than cost of service (including interest on construction), they represent the value of the privilege of using the highway, or the value of a private roadbed which is in effect a continuous parcel of land. Such a value is a ground value, and a tax on it cannot be shifted. The users of the service will not be affected by taxation of the corporation unless the tax more than absorbs this monopoly value. They pay the tax, but unless the government reduces rates they will pay that amount anyhow; but the corporation, if untaxed, will keep it.

There is only one perfect monopoly, the ownership of the site value of land. A tax on land value is not shifted, because the value of land is the relation of any piece of land to all other land. It is not a question of competing with some other form of utility. The value of land is at all times fixed by its desirability. No reduction of the tax will persuade or compel the owner to take less in rent nor will an increase in the tax enable him to obtain more. The value of a store site is determined by the business that can be done there, and the tax upon the site does not enter into consideration when negotiating for a lease. The value of a house site is determined by the competition of

those who desire it, and neither their ability nor willingness to hire it is affected by the amount of tax the owner pays.

The tax on buildings is another matter, for the production of buildings is a manufacture, and their cost is fixed by the same rules of supply and demand as govern other manufactured products. This difference in the character of land and buildings is often overlooked because they are taxed together as real estate.

While rental values have been used for illustration, the same principles of shifting apply to the price of land. The selling price of land is fixed by the net rental value. The gross rent is not changed by taxation, but the more gross rent is taken by taxes, the less will be the net rent and the smaller the price a purchaser will pay. It is unnecessary to elaborate on this point, but attention is called to it, because our taxes are nominally based on the selling price of land, when in reality that price is an untaxed value. The real basis of both sale price and tax is the rent any piece of land will command in the market.

A tax based on rentals of improved real estate and collected directly from the tenants is really an indirect tax on improvements because it falls on used property only. While it might help to relieve the owners of both used and unimproved land from some real estate taxes, it would somewhat reduce the rents received by the owners of used land for their improvements. But this reduction could not equal the addition to the tenant's expenses made by the tax.

The various classes of taxes that have been considered show wide divergence in their final effects. Some are shifted that should be shifted, and others that should not. And of those that cannot be shifted, some fall justly upon those people who should pay, while others are unfair and harmful. The fairness of a tax, therefore, cannot be judged by the mere fact of shifting or non-shifting.

Just taxation requires that payments for the support of government shall be in proportion to the benefits received or the special privileges enjoyed. There are at present many governmental activities whose benefit to individuals cannot be adequately measured, and many public expenditures that are not reflected fairly in ground values. Unless public expenses

are restricted to matters whose cost can be fairly distributed, there will be an excuse, even if not a necessity, for raising a good deal of revenue by special taxes. These should conform to the following rules:

1. Taxes should be so levied as to bear with equal weight upon all persons similarly situated.
2. Taxes should be so devised as to be cheaply and surely collected.
3. Taxes should not give any industry, by their incidence, an advantage over a competitive industry.
4. Taxes should fall on property, not persons, and upon visible property, not on the papers which show ownership of the property.
5. Privileges should be taxed in connection with the visible property through which they are exercised.

When taxes are effectively collected, the one who buys goods (or hires a service) pays through increased price every tax that has been laid anywhere along the line upon the materials in the goods or on the processes of making and bringing them to him — except where the tax was on a monopoly. Certainly if consumers are to be taxed in this indirect way, taxes should be so levied that consumers in the same class will pay the same tax.

The "general property" tax system does not shift taxes equally. Taxes are collected from the consumer that are not turned over to the government, while a few persons in the same class pay more taxes than they can collect under the stress of competition. To a large extent it prevents the final taxpayer from knowing that he is the one who pays the bills, and thus delays the adoption of a just system of taxation.

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